

**VIA E-MAIL AND FEDERAL EXPRESS**

September 28, 2012

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: File No. 4-652; SEC Technology and Trading Roundtable

Dear Ms. Murphy:

The self-regulatory organizations (“SROs”), broker-dealers and buy-side firms listed at the end of this letter (the “Industry Working Group”) came together to discuss potential public policy initiatives to address significant unintended market activity that could arise from technology issues. As a result of those discussions, the undersigned SROs are submitting this comment letter in advance of the Securities and Exchange Commission’s (“SEC”) October 2012 Technology and Trading Roundtable to share our primary recommendations. We are encouraged by the SEC’s decision to hold a roundtable with market technologists and hope that these and other suggestions will provide the SEC and the roundtable participants with specific proposals to discuss.

**Background**

We formed a working committee that includes exchanges, SROs, broker-dealers, buy-side firms and clearing organizations that is designed to bring industry participants together to discuss what actions the industry can take to improve the stability of the markets without inhibiting the ability for firms to conduct their normal business. The initial effort of the Industry Working Group has been not only to identify solutions to address a situation similar to what occurred at a major broker-dealer in August, but also to address myriad future situations that cannot be anticipated. What was unique about the recent situation was that despite abnormally high order and trade volume, prices did not dislocate significantly, so that previously enacted market structure controls such as single stock circuit breakers or clearly erroneous execution rules did not halt activity before significant harm was done and did not provide the ability to reverse the incident-related trading activity.

Participants on the Industry Working Group concluded that supplemental controls could serve to further mitigate the risks associated with technology problems that are either not caught by broker-dealer risk management systems or that occur due to some other market event. To be clear, the measures considered by the Industry Working Group, if implemented, would not be meant to replace or ameliorate the existing controls that broker-dealers are subject to, most notably the recently enacted Market Access Rule (Securities Exchange Act Rule 15c3-5) and their existing supervisory responsibilities, nor any future regulatory enactments. Rather, the idea was to construct complementary tools to

potentially catch extreme events and prevent market disruption where the other control mechanisms may not prevent anomalous activity. As any one individual safeguard does not comprehensively eliminate risk in all situations, we believe that a multi-layered approach with multiple, independent, coordinated and overlapping risk checks is important.

To that end, the Industry Working Group considered a number of broad topics, including whether modifications to existing market mechanisms such as single stock circuit breakers, the Regulation NMS Plan to Address Extraordinary Market Volatility (“LULD Plan”) and the clearly erroneous execution rules should be made. In addition, we discussed a number of different methodologies that could be used to control activity. The primary suggestions of the Industry Working Group were as follows:

1. Establish limits at individual SRO’s that track the “Peak Net Notional Exposure” for each individual participant member firm that would allow limits to be placed on overall and/or categories of activity (more detail below). These triggers would measure post-trade exposure on an automated basis, would be mandatory for all broker-dealer SRO participants, and would potentially be accessible to members’ clearing firms.
2. Further study to develop other potential quantitative controls to better detect abnormal trading behavior in real-time;
3. Evaluate whether a longer-term consolidated control mechanism could be built at DTCC’s clearing agency subsidiaries.

Although this is not an exhaustive list of options available to improve market stability, we believe these items can be implemented efficiently on an industry-wide basis and, with respect to the first two items listed above, on a coordinated basis. Committee members agreed that establishing firm guidelines based on quantitative measurements will assist in providing broker-dealers, investors and regulators with advance knowledge of the steps that will be taken should a trading abnormality occur. In addition, providing certainty of the standards to be applied is critical to restoring confidence and reducing volatility with respect to aberrant trading activity.

### **Existing Protections**

Exchanges, non-exchange market centers and broker-dealers currently benefit from several risk-management and price discovery mechanisms meant to prevent and address large market swings, which indirectly limit the impact and risk of unintended trading activity due to a system issue. Some of these existing mechanisms, such as the single stock circuit breakers and clearly erroneous execution rules, as well as anticipated future mechanisms, including the LULD Plan and Market Wide Circuit Breakers, are all mandated and enforced by either the SEC or the SROs. Additionally, tools are available through third parties that specialize in risk-management services. In fact, most participants rely on both their own internal risk management tools as well as those provided by third parties.

Broker-dealers, which are an integral customer base for exchanges, are required to comply with the SEC’s Market Access Rule. This rule requires, among other things, that broker-dealers establish risk management policies and procedures with respect to capital and credit thresholds. Broker-dealers may also have internal and third party risk management tools available to them. These rules also apply to non-exchange market centers operated by broker-dealers.

The Industry Working Group additionally spent time discussing the single stock circuit breakers, the LULD Plan and clearly erroneous execution rules in the context of whether enhancements should be made to the existing or forthcoming rules given some of the recent market events. The Industry Working Group concluded that while there are no obvious changes that need to be made:

- The LULD Plan already contemplates in Section VIII(B) (Phase II – Full Implementation), that “[s]ix months after the initial date of Plan operations, *or such earlier date as may be announced by the Processor with at least 30 days notice,*” (emphasis added) the Plan shall apply to all NMS stocks and extend to full Regular Trading Hours. We propose accelerating the implementation of Phase II to an earlier date soon after a successful launch of Phase I.
- While there was some detailed discussion of the clearly erroneous execution rules and whether some of the percentages used within the rule should be modified, there were no major structural recommendations made by the group. However, there was consensus that the clearly erroneous execution rules should be modified to fit better into the LULD Plan framework.
- Furthermore, it was agreed that the clearly-erroneous execution rules must remain metric-based, and any movement to discretion around clearly erroneous determinations would lead to lack of certainty that would increase the likelihood and severity of market disruptions.

#### **More Detail on Potential Enhancements**

The Industry Working Group supports an effort to establish triggers at the SRO level set to Peak Net Notional Exposure.<sup>1</sup> Preliminary data reviewed indicates that operating this structure would have helped with respect to recent market events. Although there are several variations of how this could be implemented, and some details would still need to be sorted out, for discussion purposes, we have established the following high-level structure:

- SRO controls would be built to track “Peak Net Notional Exposure” to monitor for excessive trading behavior from the opening over the course of the trading day. Levels could be adjusted to account for changes in overall market and/or Exchange volumes to reduce the potential for false positives on busy market days.
- Peak Net Notional Exposure would be calculated by adding net long positions with net short positions on an absolute basis per symbol.
  - Example:
    - Buy 100 shares of a \$10 stock XYZ then sell 40 shares, counting as \$600 long XYZ
    - Short 100 shares of ABC then buy 20 shares, all at \$5, counting \$400 short ABC
    - Long \$600 XYZ, short \$400 of ABC, counting as \$1000 net notional exposure
- In conjunction with each SRO, member broker-dealers would establish limits on a session/port/mnemonic level which could be aggregated as warranted.

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<sup>1</sup> The Industry Working Group focused its efforts on new control mechanisms at exchanges because other securities market centers already have broad obligations to implement controls of this nature under SEC Rule 15c3-5.

- SRO's would individually monitor the broker-dealer's trading activity and generate an automated alert when the broker-dealer reaches previously defined percentage(s) of the notional amount.
- The firm would review and determine the reasons why they may be exceeding such thresholds and, if appropriate, increase the peak threshold.
- If the firm breaches its set limit, the SRO will shut down the trading session.
- A confidential notification could be sent to other SRO's indicating that a firm's trading is halted (however, this will require additional vetting as not all firms are members of all SROs).
- Trading sessions that have been terminated by the SRO would not be reengaged until verbal confirmation from an authorized individual at the broker-dealer is received and accepted by the SRO.

Secondarily, the Industry Working Group considered various other methods that may also provide an additional level of control (e.g., gross open notional exposure, volume-based triggers). Although these items are still being vetted, we believe other possible options deserve further discussion.

### Other Suggestions

In the course of discussing the above items, the Industry Working Group also discussed the opportunity for the industry to enhance practices in the marketplace. While not an exhaustive list, some of the items that should be considered by the industry:

- **Utilization of Drop Copies.** Most market centers make Drop Copies available for customers to be able to aggregate and monitor risk independent of the direct order path. The Industry Working Group discussed whether all market centers should be required to make drop copies available, and firms should utilize these tools to reconcile their internal view of trading activity with that of the market centers as soon as possible to ensure the early detection of issues from a centralized risk-management perspective. An independent risk-management path would ensure that if the primary trading path is having issues, the executing firm is still being informed of positions and risk.
- **Practices for Code Testing and Deployment.** We expect this to be a robust area of discussion at the SEC Roundtable. While testing mechanisms can always be improved, they will not detect all possible errors and should be evaluated together with other safeguards and controls.
- **SRO and Broker-Dealer Coordination around shut-down situations.** Ensuring firms have the right escalation procedures when contacted about a suspected problem, and SROs have the right contact information to discuss suspected issues with appropriate authorized employees.

### DTCC Considerations

As the cross-market clearing agencies for the US markets and in their position at the end of the process chain as the ultimate receiver of the potential risks resulting from technology-related and similar events, DTCC's clearing agencies are in a unique position to analyze opportunities to mitigate potential systemic risks. Over the past few years, National Securities Clearing Corporation (NSCC), DTCC's clearing agency for the US equity markets, has developed two proposals for modifying its rules, both of which remain under review at the SEC, that could assist it in addressing the risks that arise from technology issues.

1. NSCC submitted a rule filing to the SEC in 2006 proposing to modify its trade submission practices to require all locked-in trade data to be submitted on a near real-time basis. The proposal was designed to significantly reduce the operational and systemic risks that result from trade data not being submitted real-time, especially from firms that delay trade submission so as to pre-net their data. Notably, pre-netting and delaying submission of trade data to the clearing agency until late in the trading day limits NSCC's ability to effectively monitor counterparty credit risk exposure and to risk manage those trades on an intra-day basis.

2. In 2008, NSCC proposed to accelerate its trade guarantee, which currently attaches at midnight of one day after trade date ("T+1"). An accelerated trade guarantee would benefit the industry particularly by mitigating counterparty risk and the parties' inability to assess that risk by having NSCC become the central counterparty to transactions at an earlier point in the settlement cycle. Also, with the rise of real-time trade submission, an accelerated trade guarantee would provide NSCC's members with a dramatic reduction in intra-day counterparty exposure.

If approved, both proposals would contribute to the goal of mitigating counterparty risk and would provide a means for NSCC to identify cross market credit issues on a timelier basis.

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We thank the SEC for the opportunity to share our views. While markets are complex and any initiatives need to be flexible and considered in the context of any other changes being contemplated, we hope that these suggestions are helpful in advancing the conversation. We look forward to the October 2<sup>nd</sup> Roundtable, and to discussing our suggestions in further detail.

Signed,



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